Issue 1: Purchase-as-Produced Contracts

The Matter

The company is an industrial entity that is transitioning its business in line with the Paris Climate Agreement. In addition, the market and the company's customers demand products that are produced with green energy. To secure the company's own demand of energy from renewable sources, the company enters into a (physical[1]) power purchase agreement with an operator of wind energy facilities. The contract obliges the company to acquire a fixed share (e.g. 50%) of the wind energy produced by a wind park of the operator. The price per unit for the energy is fixed in advance and remains stable throughout the contract duration of 25 years. The operator does not guarantee a specific amount of output (energy) but estimates with certain probabilities (e.g. 50%, 75%) an expected amount. The energy provider feeds in the energy produced to the grid and transfers the "energy credits" to the account of the company in exchange for the fixed consideration per unit.

The total energy demand of the company by far exceeds both the contracted share of the estimated output and the contracted share of the peak output of the wind park. However, the company does not operate its production facilities 24/7 but pauses production during the night times, on weekends and holiday season. There is thus a mismatch between the demand profile of the company and the supply profile of the wind park.

Since the company is obliged to acquire the energy of the wind park in the amount (e.g. 50% of the current production volume) and at the time it is produced and the company has no feasible option to store the energy, the company sells energy that cannot be consumed immediately (e.g. on weekends or overnight) to the spot market and repurchases (at least) the same amount from that market at times when the production facilities are operated. In other words, the energy provider continues to transfer the amounts of energy fed into the grid to the account of the company and the company has to sell unused amounts from its account to third parties. The process of selling and repurchasing is designed to be an autopilot that acts without the intention of trading to realize profits and has the sole (and documented) intention to enable the entity's operations. The process of selling and repurchasing is usually delegated to a service provider for a fixed or formula based fee. Transportation fees for the use of the grid is not considered for purposes of this example.

The company views the difference in prices (lower prices during night times, on weekends and during holiday season when production is paused vs. higher prices when repurchased on spot markets during peak times) as costs of storage, i.e. it uses the energy spot market as a storage facility. The company does not operate as a trading party in the market, the production schedule and the consumption profile dictate spot price transactions.

Accounting for the contract

On the date of inception of the contract, the company regards the sole purpose of this power purchase agreement as a contract to buy a non-financial item as it is entered for the purpose of the receipt of energy in accordance with the company's expected usage requirements as laid out in IFRS 9.2.4. The company does not designate the contract as measured at fair value through profit or loss in accordance with IFRS 9.2.5.

The company further analyses whether the contract can be settled net in cash in accordance with IFRS 9.2.6.

Note: for the purpose of this discussion, it is assumed that the conditions do not change throughout subsequent periods and that some market transactions become necessary for unused amounts of energy. The company is always in a net purchaser position, i.e. it buys more energy from the spot

[1] Meaning that both, the producer and the entity are connected to the same power grid.

market than it has sold to it based on a monthly view (meaning that for every calendar month, the company has purchased more energy on spot markets than it has sold). The average purchase price exceeds the average sale's price, so that the company incurs expenses for "storing" the energy on sport markets which is part of the fee paid to a service provider involved to sell unused amounts of energy to and repurchase additional demands from the grid/spot markets.

View A

The company assess at inception of the contract that

a. the terms of the contract do not provide for an option to settle net in cash or by exchanging financial instruments.
b. the company has no practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments.
c. the company intends to sell unneeded energy out of the contract to the spot market and also intends to purchase at least the same amount of energy at times when it is needed. The company uses the spot market as a storage mechanism and does not intend to generate profits from those transactions although it cannot rule out that some transactions will lead to profits or losses. Transactions on the spot market are solely used to store the energy.
d. the company assesses the non-financial item to be readily convertible to cash as there is an active market where unused energy can be sold and purchased at any time.

The company concludes that the own-use-exemption applies to its contract because it is entered into and continues to be held for the purpose of taking delivery of the non-financial asset (energy) in accordance with the entity's expected (energy) consumption.

View B

The company expects transactions on the spot market already at inception of the contract for the amount of energy it cannot use when it is produced. Under View B this would disqualify the contract from the application of the own-use-exemption because the contract was not – in its entirety – being held to the purpose of the receipt of the energy at the specific time of production (IFRS 9.2.4) but with some anticipated sales transactions.

View C

As the company intends to sell unused energy to the spot market, the company creates a practice of settling similar contracts on the spot market and therefore the contract is not entered into for the purpose of the receipt of the energy (IFRS 9.2.6(b)).

View D

Under this View D, the transactions on the spot market may lead to a breach of the requirement set out in IFRS 9.2.6(c) (generating profit from short term fluctuations in price or dealer's margin) because the company cannot rule out that profit arises from some sales transactions, even though this is not intended.

Views B-D would all result in recognizing the contract as a derivative financial instrument.

<u>Discussion</u>

As laid out above, there are several ways to interpret the requirements of IFRS 9.2.4-9.2.6 which gives rise to diversity in practice. Failure to meet the requirements of the own-use-exemption results in a mandatory recognition as a financial derivative at fair value. Given contract durations of 25 years and above, the fair value of such contracts is both difficult to measure and subject to enormous volatility and likely leads to massive effects in the company's statement of financial performance when changes in the fair value are recognized in profit or loss. It would also decouple the effects of the company's efforts to secure its supply of energy from the operating results as the fair value changes will occur and be presented before the consumption of the energy, the production phase and the sale of the output manufactured using this energy. We observe an increasing number of such transactions and thus believe that the issue is increasingly widespread and will have significant effects on those entities affected.

We therefore think that clarification is needed on how IFRS 9 is to be applied. In addition, we believe that the economic phenomenon and the intention of the company when entering the contract is not adequately reflected by a treatment of such contracts as derivative financial instruments, solely because there is no feasible way to store the quantities of energy involved and the company has to use the spot market as a storage mechanism. We also question whether accounting for such contracts as derivative financial instruments would adequately depict the operating performance of the company, since energy costs would affect the operating profit at their spot prices and the effect of the Power Purchase Agreement (PPA) containing fixed prices would occur as a measurement adjustment in periods different from the period of consumption.

Issue 2: Settlement of power purchase contracts

The Matter

Company B has contracts to purchase natural gas for use in its own production facilities. The company used its planning to derive its estimated gas demand for the next 12 months. The company contracted 80% of its forecasted demand in forward contracts to fix the price and secure physical supply in advance. The remaining 20% of the forecasted demand are procured on spot markets on a short-term basis. The company uses this mechanism already for quite some time and has never settled any contracts net in the past but has taken all amounts as contractually agreed upon. The contracts themselves did not provide a net settlement option. Therefore, it has classified all existing contracts in own-use-contracts in accordance with IFRS 9.2.4.

In the light of the current economical and geo-political environment, local governmental authorities called for voluntary energy saving efforts to ensure sufficient supplies. It also stated, that a lack of supplies would force the government to restrict the use of energy for certain industries, to which Company B belongs. To prevent any restriction and maintain its operations, Company B invested in alternative energy resources and improvements to save energy and reduced its demand. It achieved significant energy savings, reducing its demand by 30%. Since not all of the forward contract volume that the company already had in place (and which were classified as own-use-contracts) was needed any longer, the company settled some of its contracts with the supplier by agreeing to compensate the supplier for any loss the supplier would suffer and receiving compensation from the supplier if the supplier makes a profit when selling the unused volumes of natural gas on the spot market compared to selling it to Company B. The settlements were structured as a net payment for all unneeded amounts at the point in time where the supplier and the company have reached a settlement agreement calculated as the product of the amounts to be settled and the difference between the fixed price of the contracts and the then current market price.

The company continues to regard the primary purpose of the natural gas purchase agreements as contracts to buy a non-financial item as it is entered for the purpose of the receipt of energy in accordance with the company's expected usage requirements as laid out in IFRS 9.2.4.

Accounting for the contract

Before the settlement, Company B made use of the own-use exemption and did not recognize the forward contract in accordance with IFRS 9.2.4. As the company has settled some of its contracts in cash, the company assesses whether it has created a past practice of settling similar contracts net in cash in accordance with IFRS 9.2.6(b). The entity concludes that, if such a practice was created, similar contracts would be tainted and there was a need to reclassify these contracts and recognize them as financial derivatives.

View A

Company B has no history of net settlement for similar contracts. It assesses that the current economical and geo-political environment were unforeseeable at the inception of the contracts. Even though the governmental call for energy saving efforts was voluntary, the company needed to act in order to safeguard its operations and production.

Company B therefore concludes that is has not created a practice of settling such contracts net in cash because the circumstances are extraordinary and would not be expected at inception of the contract nor to recur regularly in the future. Therefore it does not reclassify similar contracts as derivatives.

View B

Even though the company has not had any settlements in the past, nor does it expect to do so again in the future, the company considers that it has created a practice of settling such contracts net in cash since the governmental call for energy saving issues was voluntary. It was not entirely clear whether restrictions would have applied in case the company had kept its operations unchanged. Thus, all similar contracts entered into in the future are reclassified as derivative financial instruments (i.e. they are "tainted") in accordance with IFRS 9.2.6(b).

Discussion

IFRS 9 does not describe or provide guidance on the term "practice (of settling net in cash)". It seems unclear how an entity would treat unforeseeable events that are not expected to reoccur in the future. Accounting literature concludes that the criterion should be read "very narrowly", i.e. that voluntary actions always lead to creating a practice of settling net in cash. It is also not clear at what point in time such contracts would become "untainted" as a "practice" would no longer be assumed.

In our view, judgement should be applied to examine whether a practice is established. We think that a practice should also involve an expectation of similar transactions in the future or clear evidence of past settlements. Companies' reaction to unforeseeable events or developments (e.g. pandemics and wars that lead to unexpected disruptions, and government policy decisions which could potentially lead to financial or other penalties) with regard to contracts they have entered into before such an event, should not create a practice. Consequently, such settlements should not "taint" similar contracts that continue to be held for the purpose of taking delivery. Given the wide reaching effects a tainting could have, we see the issue as pervasive. Since such settlements increased in the light of the current geo-political situation and are likely to occur in the future if the market pressure forces entities to change their energy sourcing, we believe that the issue is widespread.

Issue 3: Oversized Contracts

The Matter

Company C intends to secure its energy demand by entering into power purchase agreements with providers of renewable energies (wind and solar) which provide for a fixed price per unit. The company is able to reliably plan its demand. In contrast, the power purchase agreements do not promise a fixed amount of output. Given the dependence on weather conditions, the energy provider offers to Company C only an expected output of its facilities (e.g. 50% of the output of its solar farm) which it cannot guarantee but only estimate with certain probabilities (e.g. a 50% or 75% confidence level).

Company C assesses (based on information provided by the energy provider) that,

- with a probability of 10% the solar farm produces its peak output, and the company would receive 130% of its energy demand.
- with a probability of 75% the solar farm operates under most probable conditions, and the company would receive 95% of its energy demand.
- with a probability of 15% the solar farm operates under most unfavorable conditions, and the company would receive 50% of its energy demand.

The company plans accordingly to receive 95% of its energy demand from the provider and to procure any additional demand on the spot market. The same applies if the actual output of the energy provider is lower that the most probable amount. In the case of an output in excess of the Company C's demand, the company would sell the excess amount on the spot market and repurchase it there to compensate any future shortfall if necessary (although it is not certain that the shortfall would match the sales). The contract does not permit net settlement and the company has no history of net settlements or profit taking of contracts that were classified as own-use in accordance with IFRS 9.2.4.

<u>Accounting for the contract</u>

At contract inception, Company C assess the contract for its eligibility to be treated as an own-use-contract in accordance with IFRS 9.2.4. The company's intention is to take delivery of the energy and so is entered into for the purpose of the receipt of the energy in accordance with the company's expected usage requirements. It is ***probable*** (but not certain) that the output of the contract will be less than the forecasted energy usage.

However, IFRS 9.2.4 uses the term "expected" only in connection with the "entity's expected usage, purchase, sale or usage requirements". It is therefore unclear, whether the company should refer to the expected amount of energy to be received by the energy provider.

View A

Since the output of the energy provider is variable by nature, the only way to assess the amount of output is by the use of probabilities. The fact that the amount of energy may exceed the demand of Company C is not most probable but possible. Company C therefore assumes that it assesses the contract based on the expected (most probable) amount of output to assess whether the contract is in line with its expected usage requirements. Therefore it applies the own-use-exemption.

View B

Since Company C is exposed to the possibility of amounts of output that exceed its demand, Company C assumes that such contracts do not fall under the scope of the own-use-exemption, because there is a possibility of taking delivery of the energy and selling it within a short period and so the contractual amounts may not wholly be for the purpose of the company's own consumption. Thus, the contracts will have to be recognized as derivative financial instruments.

Discussion

The inherent volatility in output is a central characteristic of renewable energies and unlike the conventional production of energy. Consequentially, expectations about amounts that will be received become necessary to plan consumption and secure supply of renewable energy. Given the increased and further increasing importance of renewable energies, we think that View A is most suitable as it would not disincentive companies that use renewable energies and allow them to better present their operating performance (as explained in the discussion of Issue 1, we do not believe that accounting for such contracts as derivative financial instruments presents faithfully the transaction as the primary objective is securing the supply of energy to enable a company's operations).